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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)
)
)

Price Cap Performance Review)
for Local Exchange Carriers)
)
_____)

CC Docket No. 94-1

TO THE COMMISSION

REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

ROBERT M. LYNCH
RICHARD C. HARTGROVE
THOMAS A. PAJDA

One Bell Center
Room 3520
St. Louis, Missouri 63101
(314) 235-2507

ATTORNEYS FOR
SOUTHWESTERN BELL TELEPHONE COMPANY

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CC DOCKET NO. 94-1

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SUMMARY*

As SWBT predicted in its Comments, the parties in this proceeding have lined up into two camps: those that wish to have the price cap LECs facilitate further economic growth and national productivity, and those that do not. The battle lines thus having been drawn, the Commission must now decide whether it is to move price cap regulation forward toward more economic benefits, or to undo the little progress that has already been made, thereby capping the potential benefits of encouraging investment that would improve U.S. competitiveness.

Competition already exists in LEC markets. None of the parties filing comments convincingly show anything to the contrary. While some of the parties incorrectly cite low market shares as evidence of the lack of competition, these parties define the relevant markets much too broadly and drastically overstate any possible relevance of market share data to competition and lack of market power.

Given that competition exists and is rapidly increasing further, the relevant question is not how much competition exists today, but how quickly it can be expected to develop and how should price cap regulation accommodate that development. Viewed this way, the Commission should find ways of adjusting the price cap regulatory scheme to adapt to competition as it accelerates, instead of using this proceeding to handicap the LECs as competition grows around them. SWBT's proposals in this docket outline a proper method of making price cap regulation an "adaptive" plan. These proposals would allow price cap regulation to automatically adjust to the growth of competition, instead of making price cap

* All abbreviations used herein are referenced within the text.

regulation a means to prohibit the price cap LECs from participating in the explosion of competition.

LEC competitors and customers should not be allowed to argue here for tighter price cap restrictions on the grounds that competition does not exist while the actions of competitors demonstrate that customers have choices for interstate access services. LEC customers and competitors are blatant in their attempts to make price cap regulation into virtual rate of return regulation. While some of the parties complain about LEC earnings during the initial price cap review period, LEC earnings are comparable to those at the thirty-fifth percentile of the S&P Industrials for this same period. MCI complains that the earnings process is gamed by firms in the fourth quarter of each year, but it is clear that LEC behavior differs not from that of MCI or any other firm when it comes to end-of-year expenditures.

No party has been able to show that LEC earnings have been unreasonable. Rate of return earnings constraints should be relaxed, not tightened. Sharing should be eliminated and the productivity factor should be decreased. Adjustments should be made to the common line formula.

Predictably, some parties have attempted to make this proceeding into a rate of return represcription case. Cost-based ROR regulation concepts are totally inconsistent with incentive regulation. Neither the evidence nor the objectives of incentive regulation support earnings-based adjustments to the price cap plan.

Other changes to price cap regulation given the current state of competition are necessary. Pricing flexibility should be broadened. Baskets and bands should be restructured along functional lines and the rules should be changed to encourage new services.

Recommendations to restrict pricing flexibility, limit the introduction of new services, and to handicap the competitiveness of the LECs, should all be rejected.

Finally, other subjects in this docket should be considered in light of competition. Service quality reporting should not be expanded to give advantages to LEC competitors. The price cap LECs should have the opportunity to recover accounting changes and other exogenous cost amounts in their prices like firms in nonregulated markets.

While the submission of these Reply Comments marks the end of the formal pleading cycle, parties will certainly continue to promote their positions under the ex parte rules. In considering the filings already made and those yet to come, the Commission should weigh whether the proposals offered facilitate economic growth and promote national welfare, and should only adopt those that do.

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Southwestern Bell Telephone Company (SWBT), pursuant to the Notice of Proposed Rulemaking released February 16, 1994,¹ hereby files its reply comments in this proceeding. As demonstrated in its Comments, and as further shown here, SWBT's proposals will facilitate economic growth and national productivity and will significantly improve the current Local Exchange Carrier (LEC) Price Cap Plan. In contrast, many of the proposals of the competitors and customers of the LECs will not provide the long-term benefits consistent with the Commission's and the Administration's objectives. None of the opponents present any credible evidence to the contrary.

I. **BACKGROUND** (General Issues 1, 2)

The parties in this docket can be generally classified into four categories: (1) the LECs;² (2) direct competitors of the LECs;³ (3) the customers of the LECs;⁴ and (4) a mixed

¹ Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687 (1994) Notice of Proposed Rulemaking (NPRM).

² Ameritech; Bell Atlantic Telephone Companies (Bell Atlantic); BellSouth Telecommunications, Inc. (BellSouth); Cincinnati Bell Telephone Company (Cincinnati); Eagle Telephonics, Inc. (Eagle); GTE Service Corporation (GTE); Lincoln Telephone and Telegraph Company (Lincoln), National Rural Telecom Association (NRTA); National Telephone Cooperative Association (NTCA), NYNEX Telephone Companies (NYNEX), Organization for (continued...)

group other of parties⁵ including regulators and groups particularly affected by future telecommunications policy. The customers predictably argue for lower prices for LEC services. The direct competitors of the LECs present a litany of recommendations to the Commission that would severely restrict the LECs' ability to be effective competitors. While predictable, these recommendations by customers and competitors of the LECs must be considered not as suggestions to improve the LEC price cap system, but as attempts to sway public policy to achieve specific pricing objectives and competitive advantages.

SWBT's Comments detailed the consumer welfare gains that would result from adoption of its proposals. Others offered differing views and proposals, but in particular, the analyses sponsored by Ad Hoc stand out as the most lengthy of the opposing views.

²(...continued)

the Protection and Advancement of Small Telephone Companies (OPASTCO), Pacific Bell and Nevada Bell (Pacific Bell); Rochester Telephone Corporation (Rochester), Southern New England Telephone Company (SNET); Sprint Corporation (Sprint); Southwestern Bell Telephone Company (SWBT); United States Telephone Association (USTA); U S WEST Communications, Inc. (U S WEST).

³ Association for Local Telecommunications Services (ALTS); AT&T Corp. (AT&T); California Cable TV Assoc. (CCTVA); Competitive Telecommunications Assoc. (CompTel); Intermedia Comm. (IC); MCI Telecommunications Corp. (MCI); MFS Communications Company, Inc. (MFS); Sprint; Teleport Communications Group, Inc. (Teleport); Time Warner Communications (Time Warner); WilTel, Inc. (WilTel).

⁴ Ad Hoc Telecommunications Users (Ad Hoc); Aeronautical Radio, Inc. (ARINC); AT&T; CompTel; Government Services Administration (GSA); International Communications Association (ICA); MCI; Sprint; WilTel; Tele-Communications Association (TCA).

⁵ American Library Assoc.(ALA), Computer & Communications Industry Assoc., (CCIA), Citizens for a Sound Economy (CSE), Council of Chief State School Officers and the National Assoc. of Secondary School Principals (School Officials), Office of Consumers' Counsel of Ohio (Ohio), Pennsylvania Office of Consumer Advocate (PaOCA).

Nevertheless, as shown in Appendix ECONWEL, Ad Hoc's views are also the most seriously flawed, and should be dismissed.

In the following Reply Comments, Section II explains that competition currently exists in many of SWBT's markets and is rapidly growing. Based on the competitiveness of these markets, Section III shows that the Commission should reject the pleas of the LEC competitors and customers to redo price cap regulation into rate of return regulation through devices such as increasing the productivity offset. Section IV discusses the changes that should be made to price cap regulation because of the changes in competition. Finally, Section V explains that some issues, such as service quality monitoring, should not be used to handicap the competitiveness of the LECs.

II. COMPETITION EXISTS AND IS INCREASING.

A. Claims That No Competition Exists Are Predictable.

A recent working paper in the academic literature lays out a positive framework for the regulatory process that explains why the direct competitors of the LECs predictably have opposed and will continue to oppose any improvements in the regulatory environment affecting the price cap LECs.⁶ The paper notes that in the past decade, there has been a growing recognition of the "differential effects" of public policies on firms, creating "winners and losers" within an industry.⁷ Substantial differences in size, location, market position, technology and

⁶ Robert T. Blau and Robert G. Harris, "Strategic Uses of Regulation: The Case of Line-of-Business Restrictions in the U.S. Communications Industry," Business & Public Policy Working Paper BPP-49, June 1992 (Blau and Harris).

⁷ See Robert A. Leone, Who Profits: Winners, Losers and Government Regulation (New York: Basic Books (1986), cited in Blau and Harris, p. 2.

profitability across firms cause companies within the same industry, or competing industries, to be affected differently by any given regulation or public policy.

Such differences in public policy -- whether intended or not -- can substantially alter the competitive position of firms in the industry. These perceived differential effects of policies cause firms to take opposite positions on various policy issues.⁸ Some firms may actually support policies that might be considered unfavorable to the industry as a whole, provided those policies shift enough advantage away from their competitors.⁹ Such intra-industry redistributive effects may often be intentional,¹⁰ although others maintain that such effects are the unintended by-product of regulation.¹¹

Public policy can also be used to advantage one industry at the expense of others. Whereas the differential intra-industry effects of public policy are at least sometimes considered unintended, there is little doubt that when one industry gains at the expense of another, the positions of interested parties are deliberate and intentional. This is the case in the U.S. communications and information industries.

There is a growing concern that many U.S. firms are forsaking the art of making a profit by adding value, and are gaming the political and regulatory processes to garner earnings. As described below, this political gamesmanship is evident in many of the comments

⁸ Blau and Harris, p. 2.

⁹ *Id.* This explains why AT&T supports a pure price cap plan for itself, but recommends an extremely restrictive version of price cap regulation for the LECs.

¹⁰ Sharon Oster, "The Strategic Use of Regulatory Investment by Industry Sub-Groups," Economic Inquiry, XX(4), October 1982, pp. 604-618.

¹¹ Owen and Noll (1982), cited in Blau and Harris, p. 2.

of the LECs' customers and competitors, who would have the Commission believe that the LECs do not now face competition and will not for some time to come.

B. The Claims That No Competition Exists Are Wrong. (Transition Issues 1a, 1c, 1d)

1. Evidence Of The Current Extent Of Competition Is Compelling.

In this regulatory proceeding, the LECs' competitors and customers claim that SWBT and the other LECs have a "monopoly" on telecommunications services in their respective service areas. This is simply not true. A monopoly is defined in Black's Law Dictionary as:

[a] privilege or peculiar advantage vested in one or more persons, or companies, consisting in the exclusive right (or power) to carry on a particular business or trade. . . . a form of market structure in which one or only a few firms dominate the total sales of a product or service.¹²

In the areas that SWBT serves, customers have numerous options for their telecommunications needs and SWBT does not have any "exclusive right" to serve these needs, nor does it "dominate the total sales" to these customers. These options include alternative access providers, interexchange carriers, electric utilities, cable TV companies, microwave, VSAT,¹³ other private networks, private pay phone providers, operator services providers and wireless carriers. Indeed, every market in which SWBT provides service is experiencing some degree of competition.

¹² Black's Law Dictionary 908, (5th ed. 1979).

¹³ VSATs are Very Small Aperture Terminal networks, which provide telecommunications services over satellite technology. SWBT, Appendix COMP, pp. 29-30.

In many markets, consumers' options currently include facility-based carriers that provide special access, switched access and local service. Most of SWBT's large business customers currently have alternative access carrier choices. SWBT provided significant evidence of the extent of competition in the high capacity special access market in its Comments.¹⁴

In addition to competition for large business customers, the small and medium-sized business market is being addressed by alternative suppliers. MFS has formed a separate business group (MFS Intelenet) specifically to target the small to medium business market.¹⁵ MFS has a stated goal of becoming a single source for the telecommunications needs of both large and small-to-medium-sized businesses. Teleport has publicly stated similar goals.¹⁶ These telecommunications providers are building full-service telecommunications service offerings -- including interexchange long distance, interstate access, intrastate access and local service.¹⁷ AT&T has a similar strategy using wireless technologies with the pending purchase of McCaw. MCI is moving in both directions with its wireless consortium and its own land-line facilities-based local network.

Cable television (CATV) companies and electric companies are also in a very good position to become facilities-based mass-market telecommunications companies.¹⁸ The

¹⁴ SWBT, pp. 9-11 and Appendix COMP.

¹⁵ "MFS Intelenet Brings True Broad-Based Competition to New York City," MFS Net-Work, Winter 1994, p. 1.

¹⁶ "Light Years Ahead in Local Telecommunications Services," Teleport Communications Group, distributed publicly in May of 1994.

¹⁷ The Regional Bell Operating Companies (RBOCs) are currently prohibited from offering this full spectrum of services.

¹⁸ SWBT Comments, Appendix COMP, pp. 17-28.

CATV and electric industries are searching for new ways to leverage their networks to improve their cash flows. The trade journals are replete with examples of technology trials and product announcements that will make these networks capable of providing basic telephone services. In fact, local telephone service is being provided today in England and in other parts of the world over CATV networks. AT&T states that, "no cable operator offers any service that is a substitute for traditional exchange telephone service anywhere in the United States today."¹⁹ AT&T's statement is misleading and should not be the basis for discarding CATV as a source of future competition. CATV companies are currently using their networks for access and local services. Time Warner recently announced plans to connect with Rochester Telephone Company to provide local service over a CATV network. Similar services are also being planned by Time Warner in other states. In fact, many CATV companies are incorporating language into their local franchise agreements to permit them to provide "cable service and other lawful services to subscribers."²⁰

SBC Media Ventures, Southwestern Bell Corporation's CATV subsidiary, has sought permission to provide residential telephone service over its Montgomery County, Maryland CATV network. However, this was not the first such request. Maryland has already granted "co-carrier" status to another company for telephone services -- that company was MFS. These applications will offer services, including interstate access services, in competition with

¹⁹ AT&T, p. 12.

²⁰ Section 1, Title 15, Chapter 8, Tulsa Revised Ordinances, Tulsa Cable Television Permit, filed with the City of Tulsa, August 2, 1993 [emphasis added]. This language is typical of language being used in the cable TV franchise agreements throughout the nation. "Other lawful services" includes telecommunications.

incumbent local exchange carriers. Trials and applications to connect interexchange carriers (IXCs) with CATV customers to complete or originate long distance calls have been around for some time. Time Warner has trialed this service in Queens, New York and is offering it in its Orlando, Florida system. Regulatory changes are needed now to respond to future competition.

In its recent examination, SWBT identified that alternate access providers are actively providing access services in approximately ninety-five of SWBT's local exchange areas. While this represents only seven percent of SWBT's total wire centers, the particular wire centers chosen by the alternate access providers represent over one-half of SWBT's total high capacity circuits and revenues. This is no coincidence.

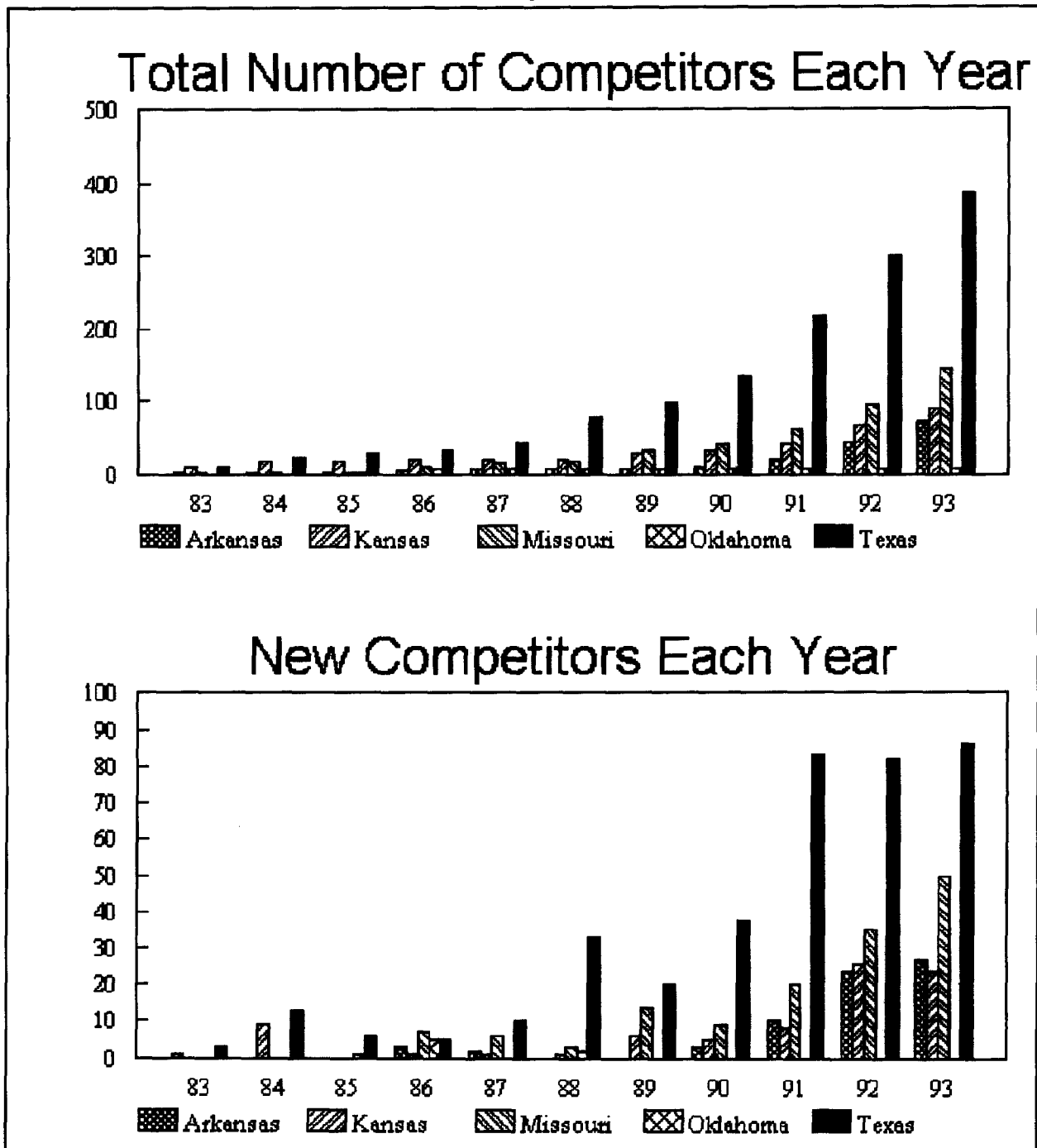
Because of the highly geographically concentrated nature of the telecommunications business, so-called "competitive" access providers (CAPs) are able to strategically and selectively address a large percentage of LEC access demand with relatively small capital outlays. When examining the buildings in which the CAPs have a presence in SWBT's major cities, CAPs have been very precise in selecting the most concentrated locations for their deployments. Buildings being served by CAPs (that SWBT has been able to confirm currently) represent at least one-third of SWBT's DS-1 services in Texas, and at least 29 percent of SWBT's DS-3 services. In Missouri, CAPs currently serve buildings representing at least 29 percent of SWBT's DS-1 services and at least 30 percent of SWBT's DS-3 services. Importantly, none of the above percentages reflect any of the effects of competition from private networks or self-supply by IXCs.²¹

²¹ Because these percentages exclude private networks and self-supply by IXCs, they drastically underestimate the effect of competition.

In geographic areas smaller than a state, the numbers are even more dramatic. In the 33 local exchange areas in the Dallas area, CAPs have been confirmed to be present in 22 of them. The 88 buildings being served by CAPs represent 74 percent of SWBT's DS-3 services and 47 percent of SWBT's DS-1 services in the Dallas area. Of the 47 local exchange areas in the Houston area, at least 21 have a CAP presence. The 87 buildings already verified as being served by CAPs represent 88 percent of SWBT's DS-3 services and 59 percent of SWBT's DS-1 services in the Houston area. Across SWBT's five-state area, CAPs have already been confirmed as having a presence in 333 buildings.²² These buildings represent 25 percent of SWBT's total DS-3 and DS-1 services. One just cannot claim that SWBT does not have competition.

In the majority of SWBT's states, the state commissions require the competitors to be registered or certified. The graphs below show the growth in the number of competitors that have obtained the required certification or registration by state regulators and the cumulative number of certified or registered competitors per state. Admittedly, the number of competitors is an imprecise measure of the competitiveness of telecommunications markets, but the direction of change is unambiguously toward greater competition and the pace of change is accelerating.

²² The verification process is imprecise; the actual number of buildings currently served by CAPs is most assuredly significantly greater than the approximately 333 that SWBT has verified. SWBT's access competitors are currently under no obligation to disclose information regarding the extent of their competition.



* Oklahoma does not require most competitors to be certified. To date there are over 125 long distance companies providing service in Oklahoma.

The second graph illustrates that the number of new competitors registered or certified each year has risen dramatically in the 1991-93 time period. This and much other evidence demonstrates that the pace of competition in telecommunications markets continues to increase. There is no shortage of competition for telecommunications business.²³ The bottom line is that this Commission must adopt a plan to address those market areas experiencing competition today as well as those that will experience rapid increases in competition in the near future. The Commission should adopt regulations that easily and adequately adapt to competition, rapid changes in technology and customer demands, and changes in legislation and regulation, at the state and federal levels.

2. Competition Is Growing Quickly.

As fast as analysts gather data on the extent of competition in telecommunications markets, that data becomes obsolete. Ten years ago, data on the extent of competition might have been considered outdated if it were more than a year old. Today, the pace of change is so rapid that in the space of weeks, one can witness profound events that significantly reshape the competitive landscape in telecommunications markets. The data on the extent of competition in access markets filed in this docket on May 9, 1994 is already significantly in need of updating. The Commission must act now to anticipate competition due to the rapid pace of

²³ Not shown in these graphs are wireless providers, CATV providers or owners of private networks. The state commissions in four of SWBT's five states do not require wireless providers or CATV providers to be registered. Also, because the owners of the hundreds of private networks are not required to file usage information with the Commission or state regulatory authorities, it was not possible here to quantify the degree to which these alternatives provide additional customer alternatives. SWBT, Appendix COMP, pp. 10, 29-30.

change in access markets. Dr. Harris states that, to his knowledge, the pace of competitive entry in access markets is virtually unmatched in the history of mature industries.²⁴

AT&T and MCI would have the Commission believe that competition in telecommunications is many years away.²⁵ However, abundant evidence to the contrary has arisen in just the seven weeks since comments were filed in this proceeding. As noted previously, SBC Media Ventures filed for a Certificate of Convenience and Necessity in Maryland for the purpose of providing local exchange service over its CATV network. The Maryland Public Service Commission granted MFS "co-carrier" status and authority to provide interexchange and local exchange service. Time Warner announced its intention to offer local exchange service in Rochester, New York, and joined in the stipulated agreement with Rochester Telephone and the New York Public Service Commission (NYPSC) staff concerning Rochester Telephone's Open Market Plan. MFS likewise announced its intention to offer local service in Rochester. In the state of New York, MCI and AT&T are among a number of newly certificated local exchange carriers (CLECs).²⁶ Teleport announced that it will begin offering local switched telephone service in Seattle as soon as it completes installation of its digital

²⁴ USTA Reply Comments, Attachment 1, Robert G. Harris (Harris Reply), p. 11.

²⁵ MCI obviously felt compelled to acknowledge its announcement of its intention to provide local services in direct competition with the LECs, although, in its comments, it characterized this "foray" into local competition as insignificant. In contrast, MCI's Chairman and CEO at its shareholder meeting stated publicly to a different audience that MCI's investment in Nextel provides MCI with a "big opportunity to go after the local exchange market by providing cordless, wireless telephone service." (Telecommunications Reports, Vol. 60, No. 22, pg. 16). It is interesting to recall that MCI originally sought to provide only private line service, stating that it was not seeking to provide message toll.

²⁶ The CLECs also include MFS, Teleport and others.

switch. All these events occurred in the short period since comments were filed, thus proving that competition is rapidly progressing, even as the Commission considers this docket.

3. The Actions Of LEC Competitors Belie Their Claims In This Docket.

The direct competitors of the LECs claim that LEC customers are locked into the local exchange company, and that this constitutes a real, or virtual monopoly. These claims are far different from the story they are telling in the marketplace.

A widely-distributed MFS brochure states: "for the first time in nearly 100 years, virtually all businesses -- large, medium and small -- have freedom of choice when it comes to selecting a local telecommunications carrier." Teleport's public literature says that:

Times have changed. Remember when you had no choice in long distance carriers? Well, now you do. And remember when you had no choice in local telecommunications services? That's changed too. Businesses are no longer dependent solely on the local telephone company for local services.

Access Transmission Services, Inc., an MCI company, states:

alternate access -- what does it mean? It means having a choice. As a telecommunications user you have a choice on how you communicate with the world.

These examples of public statements from official company brochures demonstrate that the LECs' competitors view themselves as viable alternatives to LEC access and clearly portray an absence of any local exchange carrier "monopoly" when they are dealing directly with their customers. Yet, their filings in this docket illustrate that they are trying to tell a completely different story to the Commission. In fact, most of the CAPs and IXC's, by their comments filed in this docket, attempt to draw the Commission's attention away from their aggressive and profound activities in the interstate access arena. Instead, they predictably, but

incorrectly try to perpetuate the myth that the LECs have no competition and that they are feebly struggling to compete with the LECs.

LECs' competitors and customers (including, CAPs, IXC's and other providers) are, for the most part, well established, financially strong and politically savvy companies with marketing and sales expertise. They realize that they have a competitive advantage so long as the LECs are held back from fully competing by cumbersome rules and regulations. Their claims that the LEC price cap plan should be tightened and made more restrictive are attempts to use the regulatory process to maintain existing, and in some cases impose even further, unfair competitive advantages. Even when the LECs' competitors concede the fact that the LECs do not have a monopoly on services, they propose entirely flawed examinations of "market share" and other inappropriate issues as prerequisites to the Commission's recognition of competition in its price cap regulation plan for LECs.

III. PRICE CAP REGULATION SHOULD NOT BE UNDONE INTO RATE OF RETURN REGULATION.

The purpose of this proceeding is to review price cap incentive regulation for LECs. The review should improve upon the incentive regulatory mechanism, which the Commission found superior to "traditional" cost-based rate of return/rate base regulation when it adopted the current plan in 1990.

Traditional cost-based rate of return (ROR) regulation is inconsistent with and contrary to the principles of incentive regulation. The application of ROR-based measurements and mechanisms, including the current sharing mechanism, to the price cap LECs undermines the basic profit incentives needed to encourage efficient market behavior. This proceeding

should not reverse the Commission's regulatory reform efforts by reverting to the cost-based regulation concepts that preceded the current price cap paradigm. This proceeding has not been constructed to create the voluminous and complex records needed for a formal represcription of cost of capital.²⁷

A. Price Cap LECs' Earnings Are Not Excessive. (Baseline Issue 3b)

Underlying the positions taken by a number of parties is the flawed presumption that the price cap LECs have experienced unreasonably high profits over the 1991-93 time period.²⁸ For at least three distinct reasons, the earnings experience of the price cap LECs is not unreasonable:

- The fundamental goal of price cap regulation is to encourage increased efficiency as a result of the increased earnings potential in an incentive regulation plan;
- Nonregulated firms facing comparable risk earn returns equal to or above the earnings experienced by the price cap LECs; and
- The reported earnings data required by the Commission's accounting and depreciation rules significantly over-state price cap LEC earnings relative to (a) other firms in the telecommunications industry and (b) nonregulated firms facing comparable risk.

1. Increased Earnings Was A Goal Of Price Cap Regulation.

If earnings have increased because carriers have become more efficient, then the observed earnings performance is desirable, not unreasonable. To conclude otherwise, as suggested by the LECs' competitors, presents an unfair "Catch 22" dilemma. These parties would have the Commission establish the following unfair scenario:

²⁷ See Section III. D., *infra*.

²⁸ AT&T, pp. 23-27, MCI, p. 22; GSA, pp. 4-10.

If earnings did not increase, then carriers are presumed to not have been sufficiently efficient; if earnings did increase, then the increase in earnings is presumed to be unreasonable because earnings are above the initial target return.

Such circular logic certainly is not the intent of price cap regulation. The Commission was very specific with regard to this point when it adopted price cap regulation:

LECs that can out perform the productivity level embedded in the annual adjustment mechanism are rewarded with the ability to retain reasonably higher earnings than would be available under the former [ROR] regulatory system. . . .

[c]arriers that can substantially increase their productivity can earn and retain profits at reasonable levels above those we allow for rate of return carriers.²⁹

The Commission must not now remove the very rewards that it previously deemed were desirable.

2. A Comparison Of LEC Earnings With Earnings Achieved By Unregulated Firms Indicates That Price Cap LEC Earnings Are Not Unreasonable.

Because price cap regulation was constructed with the objective of providing carriers with the profit incentives available to businesses in competitive markets, it is appropriate to compare the earnings of the price cap carriers with the earnings of unregulated firms. Such a comparison shows that the earnings experienced by the price cap LECs are not unreasonable.

Table 1 below presents the achieved earnings of the Standard & Poors' 400 Industrials (S&P 400) for the period 1990 through 1993. These earnings results are calculated in the same manner as the interstate returns on investment utilized in the Commission's price

²⁹ Policy and Rules Concerning Rates for Nondominant Carriers, 5 FCC Rcd 6786 (1990) (LEC Price Cap Order), paras. 2, 22.

cap plan for LECs. The average returns for the price cap LECs over the 1991-93 time period were 12.34 percent compared to the median return of the S&P 400 of 14.92 percent. The composite earnings of the price cap LECs places them in the 35th percentile of the S&P 400. Given the increased risk associated with investment in the regulated portion of telecommunication markets, the achieved earnings of the price cap LECs are not unreasonable. In addition, rapidly increasing competition makes additional LEC revenue streams vulnerable to competitive losses. This adversely affects LEC profitability and makes investment in the LECs more risky.³⁰

Table 1
Achieved Returns on Investment
S&P Industrials versus Price Cap LECs as Reported

	S&P 400 Industrials	Price Cap LECs (As Reported)
1991	15.16%	11.77%
1992	15.92%	12.33%
1993	13.90%	12.93%
1991-93	14.92%	12.34%

Moreover, some parties that claim that LEC earnings are unreasonably high routinely achieve rates of return that equal or exceed the reported earnings of the price cap LECs. For example, both AT&T's and MCI's return on investment exceeded the average of the price cap LECs for the 1991-93 time period as shown in Table 2 below.

³⁰ USTA Reply Comments Attachment 2, Statement by Randall S. Billingsley, pp. 4-8; USTA, Attachment 3, Larry A. Darby, pp. 7-12.

Table 2
Achieved Returns of AT&T and MCI

	AT&T's Return on Investment*	MCI's Return on Investment#
1991	13.41 %	14.22 %
1992	12.77 %	13.90 %
1993	13.49 %	12.64 %
1991-93	13.22 %	13.49 %

* As filed with the Commission.

As reported by Standard and Poors, Compustat.

3. Artificially Low Depreciation Rates Inflate Reported LEC Earnings.

As SWBT and others pointed out in their Comments, the accounting earnings reported by the price cap LECs utilize accounting depreciation rates instead of higher, more realistic economic depreciation rates. This difference significantly distorts the reported percentage returns on investment.³¹ That prescribed depreciation rates inflate earnings has been widely recognized by analysts and the financial press. A recent article states:

Telecommunications technology and legal barriers to entry into the industry are changing so rapidly these days that telephone companies should depreciate their equipment rapidly. Yet until U S West took its big charge, the company had been using depreciation schedules that stretched, for some equipment, to 30 years. This method resulted in skimpy depreciation charges to earnings and higher reported earnings.

In reporting these phony earnings did U S West, which serves 25 million customers in 14 states from the Great Plains to the Pacific Northwest, mean to deceive? Not at all. The lengthy depreciation

³¹ USTA, p. 16; SWBT, pp. 28, 92-93; Pacific, pp. 30-31, 37-38; Bell Atlantic, pp. 7-10; BellSouth, pp. 40-42; U S WEST, p. 37.